

# NAFTA: Setting the Record Straight

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## 1. INTRODUCTION

THE North American Free Trade Agreement (NAFTA) was sold on the basis that it would bring a substantial expansion of US exports to Mexico and boost Mexico's economic growth. Since its passage, however, not everything has gone as planned. In 1995 — scarcely a year after NAFTA came into effect — Mexico was in the midst of its worst economic crisis in decades. Meanwhile, rather than the anticipated expansion, US exports to Mexico went down.

Has, then, NAFTA failed? The short answer is 'no'. While many more years will be required before it is possible to make a meaningful assessment of the agreement, NAFTA's expected benefits are beginning to materialise. Trade among the three NAFTA countries has been expanding to record levels and the number of US-Mexican business partnerships is on the rise. Moreover, despite the 45 per cent real devaluation of the peso, the seven per cent drop in Mexican output and Mexico's 22 per cent fall in real wages during 1995,<sup>1</sup> US exports to Mexico were much less affected than Japanese or European exports largely thanks to NAFTA. Indeed, while exports to Mexico from the rest of the world, notably Japan and the European Union, fell by about 25 per cent, US exports contracted by less than two per cent.<sup>2</sup>

Despite these positive trends, many Americans in and out of the Congress are proclaiming that NAFTA was a mistake. To a large extent, the statements against NAFTA are based on erroneous beliefs or egregious distortions. NAFTA is blamed for US job losses or declining living standards of workers, particularly the unskilled. In reality, the impact of NAFTA on *gross* job displacement in the United States has been negligible. Furthermore, there is some evidence that NAFTA's *net* employment effect (the difference between jobs displaced and jobs created) has been positive.

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<sup>1</sup> World Bank (1997).

<sup>2</sup> Banco de Mexico (1996).

Another argument used against NAFTA is the fact that following the Mexican peso crisis the United States is running a trade deficit with Mexico. However, unless it is the result of restrictions in market access, a deficit with any one country by no means is a cause of distress in the country that is running the deficit. The success of NAFTA has to be measured by the total amount of trade it creates regardless of which country is in deficit.

Finally, while some of NAFTA's critics argue that the agreement was a cause of the Mexican peso crisis, in reality the crisis was caused by factors unrelated to NAFTA. In fact, NAFTA is an important contributing factor to Mexico's economic recovery because of its impact on export performance and foreign direct investment flows.

These misperceptions probably reflect a deep-seated frustration with rising income disparities and declining real earnings of less-skilled workers in the United States for which trade with developing countries is frequently blamed. So far, the sentiment prevailing in Congress in relation to NAFTA and its extension has been strong enough to inhibit the administration from requesting Congressional approval for fast-track authority to negotiate the accession of other countries to NAFTA or any other free trade agreement. If current trends continue, it is unlikely that the United States will be able to remain a credible player — let along a leader — in the quest for hemispheric free trade.

To construct long-lasting support in the United States for NAFTA — and free trade more generally — action is needed on three fronts. First, the administration must undertake a systematic public education effort both with Congress and the general public about NAFTA and its actual effects. Second, further steps are required to make good on the promises imbedded in so-called labour and environmental side-agreements. NAFTA critics are right in one respect: there is no reason to forego NAFTA's contribution to the protection of workers' rights, particularly in Mexico, or improved environmental conditions, especially along the US-Mexican border. Finally, identifying ways to address the rising economic polarisation and declining living standards for the less-skilled in the United States deserves greater attention on the part of policy makers. Otherwise, many lawmakers are likely to continue focusing on the wrong instrument — that is, trade protection — to combat it.

## 2. NAFTA AND MEXICO'S ECONOMIC PERFORMANCE

Was NAFTA a cause of Mexico's 1995 financial crisis? Some observers have argued that it was. However, Mexico's large and rising trade deficit was not the result of the reduction in trade barriers implied by NAFTA but was caused by an appreciated peso (that is, the dollar was allowed to become too cheap). Furthermore, while the trade deficit contributed to the peso's devaluation, there

were other events that were equally, or more, important in explaining Mexico's financial debacle of 1995.

The Mexican financial crisis was the result of a combination of, on the one hand, rising US interest rates, political shocks, and market hysteria, and, on the other, erroneous policy responses on the part of the Mexican authorities. Three events in particular — the Zapatista guerrilla uprising in Chiapas, the assassination of the PRI presidential candidate, and the assassination of the PRI Secretary General — generated a climate of uncertainty among investors during 1994. In the aftermath of the PRI presidential candidate Luis Donaldo Colosio's assassination in March 1994, Mexico lost close to \$10 billion — or about 40 per cent — of its international reserves.

While NAFTA cannot be blamed for the peso crisis, it is surely contributing to Mexico's recovery. And, economic growth in Mexico brings good things to the United States in the form of increased exports and reduced migration. The Mexican economic recovery got underway in the third quarter of 1995, and the 6.2 per cent fall in GDP exhibited that year was followed by a 5.1 per cent growth in output during 1996. Exports have been the engine of Mexico's recovery. Overall, they grew by 33 per cent in 1995, with non-oil exports rising by 47.5 per cent.<sup>3</sup> One indicator of NAFTA's role in this process is that the average rate of growth of Mexican exports to the United States was more than ten percentage points higher after 1994 than in the period 1991–1993. The sectors which showed the highest rates of growth were those where the regional integration was fairly advanced even before NAFTA: autos and auto parts, as well as textiles and apparels, food and beverages, and agriculture and cattle products.

NAFTA's impact is also observable in the behaviour of foreign direct investment, another important contributing factor to Mexico's economic recovery and future growth prospects. On average, between 1994 and 1996 foreign direct investment is almost double (close to \$8 billion a year) the amount it was in the three years preceding NAFTA's implementation. Moreover, in 1995, when portfolio flows became highly negative, foreign direct investment was 75 per cent above the level in the three years preceding NAFTA. A comparison with the previous crisis may be telling. During 1983, foreign direct investment fell to a fifth of what it had been in the previous years. Clearly, the business opportunities brought by NAFTA have had a positive impact on foreign direct investment decisions, the peso crisis notwithstanding.

Unfortunately, the economic recovery has not yet reached the pockets of the average Mexican: between 1995 and 1996, real manufacturing wages fell cumulatively by over 25 per cent. But, if current economic trends continue — and current forecasts suggest they will — real wages should start growing, albeit

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<sup>3</sup> INEGI Internet Site.

slowly, again. Still, it could take several years for Mexican wages to reach their pre-crisis levels but without NAFTA, it would have taken much longer.

### 3. NAFTA AND US TRADE

The relative size of the US economy *vis-à-vis* Mexico (about 25 to 1) will always limit the effects of NAFTA to very small orders of magnitude. Imports from Mexico as a share of total annual US imports, for example, have averaged about six per cent. Investment in Mexico is a tiny percentage of overall US investment. For example, in 1994, direct US investment in Mexico was \$3 billion or about one-third of one per cent of US gross private domestic investment of more than \$1 trillion.

Furthermore, assessing NAFTA's impact could turn into a futile exercise. The sharp devaluation of the Mexican peso and the crisis that followed clearly overshadow the effects of NAFTA's implementation. The devaluation and the recession caused a sharp decline in Mexico, US exports to Mexico, and Mexico's trade deficit with the United States of \$2.4 billion in 1993 became a surplus of \$15.4 billion in 1995. In addition, NAFTA is just one part of a continuing process of economic integration between Mexico and the United States, a process which accelerated with Mexico's trade liberalisation introduced in the mid-1980s. The benefits — and the costs — of economic integration will be spread over many years. Even in the longer run, the size of the US economy relative to Mexico will always limit the effects of trade and investment flows with that country.

Nevertheless, there are indications that NAFTA is making its imprint on both the magnitude and composition of bilateral trade flows. For example, during 1994, NAFTA's first year, trade between the NAFTA partners grew by 17 per cent over 1993, reaching a record of \$350 billion, of which \$100 billion are US–Mexico trade.<sup>4</sup> Taking a longer perspective, all of US–Mexico trade surged from \$30 billion in 1986 (a year after Mexico began its trade liberalisation) to an estimated \$140 billion in 1996.

In 1995, NAFTA worked to preserve and promote trade, despite Mexico's economic crisis. In contrast to the crisis in 1982, when Mexico re-introduced import permits for the majority of products, this time it kept its open-economy policies largely in place. Tariffs were increased to their GATT-bound levels in only a handful of sectors. But, because of NAFTA, the US — as well as other countries which had signed free trade accords with Mexico — were spared this tariff increase. Moreover, in 1995, while exports from the United States fell by about two per cent, exports from non-NAFTA countries — notably, Japan and the European Union — fell by 25 per cent. Part of the difference in export

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<sup>4</sup> Weintraub (1997).

performance between the United States and other exporters to Mexico might be attributed to the depreciation of the dollar *vis-à-vis* other major currencies in 1995. However, most must be ascribed to the expanded market access for US exporters and the growing importance of intra-industry bilateral trade, both strengthened by NAFTA. NAFTA appears to have shielded US trade from the brunt of the Mexican crisis and the increase in some tariff lines that followed.

#### 4. US EMPLOYMENT AND WAGES

Before NAFTA's approval, all opponents claimed that the agreement would lead to significant job losses in the United States. Cheap, labour-intensive Mexican imports, would outcompete US goods and plants would be attracted to Mexico by lower wages.

Three years of evidence reveals that those fears were unfounded. One indicator of the gross disemployment effects caused by NAFTA is the Trade Adjustment Assistance (NAFTA-TAA) certifications for all industries given by the Department of Labor. The *cumulative* figure between January 1994 and December 1996 equals close to 90,000 certifications. Sixty per cent of these are Mexico-related (as opposed to Canada or unspecified country). Forty per cent of this amount is due to plant relocation and the rest to employment displaced by imports. This number, however, is the total number of recipients of NAFTA-related assistance, which is not equivalent to the total number of people who may be unemployed as a result of NAFTA. USTR figures indicate that about 6,000 of the eligible recipients actually used the benefits, suggesting that the rest has probably been re-employed. Also, an accurate assessment of the net employment effect of NAFTA would need to look at job creation as well. A recent study which attempts to do this analytically found that the overall impact of NAFTA tariff liberalisation on US employment has been slightly positive.<sup>5</sup>

Moreover, job displacement may be causing real hardship for some individuals and families, but it is important to put the above figures in context. Since NAFTA, the United States has created in the order of 2.25 million jobs a year. Furthermore, according to the Bureau of Labor Statistics, total *gross* job displacements (subsequently re-employed in the majority of cases) during the first nine months of 1996 averaged 2.4 million workers per month. On a monthly basis, the NAFTA-TAA certified workers since the agreement came into effect equals 2,569 a month (82,223 divided by 32 months). NAFTA certified job displacements were only about one in one thousandth of the average monthly layoffs during the first nine months of 1996.<sup>6</sup>

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<sup>5</sup> Hinojosa et al. (1996).

<sup>6</sup> All these figures come from Hinojosa et al. (1996).

Given US wage flexibility, a more relevant measure of NAFTA-related hardship for American workers may be its effect on wages, particularly for the less-skilled. While NAFTA's effect on wages has not been estimated, the impact of trade on US wages has been studied extensively. The majority of these studies concludes that international trade explains a small share of the observed rising wage inequality and downward trend in real wages of less-skilled US workers.<sup>7,8</sup> In general, it is technological change — with its bias in favour of high-skilled labour — that is the main factor behind these trends. It may be important to note that even if trade protection may bring small, short-term relief for unskilled workers, this will be at the expense of lower growth and living standards — including those of less-skilled workers — in the future. A more fruitful alternative would be to pursue policies designed to upgrade the education and skills of the working population.

## 5. LABOUR AND ENVIRONMENT

To respond to US congressional interest in incorporating labour and environmental issues into the negotiations, the Clinton administration negotiated the North American Agreement on Labour Cooperation and the North American Agreement on Environmental Cooperation, known as NAFTA 'side' agreements. Mexico and the United States alone established the Border Environment Cooperation Commission (BECC) and the North American Development Bank (NADBANK). The BECC:

is expected to assist border states in both countries to design and finance environmental infrastructure projects certified by BECC and also to provide support for community adjustment and investment projects.<sup>9</sup>

As part of the so-called labour side agreement, a federal government level office in each country called the National Administrative Office (NAO) was created. One of its functions is to receive public complaints about non-enforcement of labour law.

The labour and environment NAFTA side-agreements were introduced to gain votes in the US Congress at the time of NAFTA's approval. However, organised labour, Democrats in Congress, and some environmentalists were not satisfied with the agreements because, in their words, they lack 'teeth': that is, no real provisions were made to use trade sanctions against violators of the side accords.

It is really fortunate that these agreements are 'toothless' in this respect. Otherwise, probably environmental and labour issues would have been frequently

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<sup>7</sup> Burtless (1995).

<sup>8</sup> Lawrence (1996).

<sup>9</sup> GAO (1994, p. 11).

used as excuses to introduce protectionist barriers and obstruct NAFTA's implementation. Not even the European Union, so keen on harmonising social standards, uses trade sanctions in the face of labour or environmental law violations. In the European Union, complaints are brought before the judicial system by the interested parties in the country where the violation took place. The rulings have to be consistent with European Union norms, but all the remedial action is undertaken within the country so that the party who has been inflicted damage receives appropriate compensation.

Still, more could and should be done both on the labour and environmental fronts by the governments and NAFTA-created institutions. One repeated concern expressed by US labour leaders is that, given the characteristics of Mexico's political system and the corporatist role played by the official unions, Mexican workers still find it hard to form and belong to independent unions. This concern is well-founded. Even in today's more democratic Mexico, independent unions may face serious obstacles to be recognised. This appears to have been the case in several of the complaints brought before the US National Administrative Office. The recommendations of NAO, however, indicate an overcautious approach in dealing with this kind of labour rights violations.<sup>10</sup> Even if NAO's formal recommendations on these matters are not the equivalent of rulings and do not lead to sanctions (i.e., fines imposed on the country where the violations occurred) under the current terms of the side agreement, greater exposure of such violations could eventually lead to a reduction in their number. This would require a stronger stance on the part of the national NAO whenever such complaints are brought to its attention even if they pertain to another of the NAFTA members.

On the environmental front, the North American Development Bank (NADBANK) could be made an effective tool to foster environmental protection and clean-up, especially along the US-Mexican border. The Bank's capital will soon increase from \$1.5 to \$2.25 billion dollars. However, since its establishment, the Bank has approved only three loans for merely \$2.98 million and issued guarantees for \$1 million. One factor behind this low level of activity is that the established procedure — projects have to be certified by the BECC before they are analysed by NADBANK in terms of their financial viability — may be flawed. Switching the order in which projects are analysed and approved may expedite loans.

Another fundamental reason for this low level of lending is that the Bank's charter obliges it to operate in strictly commercial terms. Many of the potential borrowers (local governments, NGOs, etc.), particularly in Mexico, lack the administrative experience and the ability to borrow funds or are simply not eligible because they would never be able to repay the loans required to finance a

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<sup>10</sup> Levinson (1996).

specific project. Environmental projects will need some form of subsidisation. If NADBANK cannot lend at below-market rates, other sources, such as governmental non-refundable grants or private donations, will be needed to co-finance the projects with high social returns. Although this is already happening, the scale has been too small. As every other development bank, NADBANK may eventually need a window of credit on concessional terms for the poorest and most vulnerable communities. Furthermore, the bank should probably expand its portfolio of eligible projects and include housing, education, and poverty reduction projects more generally. This would not be in violation of its charter and such projects could have important environmental effects.

#### 6. FINAL OBSERVATIONS

During the past three years, NAFTA has produced an increase in US–Mexican trade, business partnerships, specialisation in production processes, and direct investment flows into Mexico. At the same time, it has protected US exporters from the brunt of the Mexican crisis, especially in comparison to exporters from Japan and the European Union. While it is true that US exports to Mexico shrank during 1995, this fall was not generated by NAFTA but by the Mexican devaluation and the subsequent financial crisis. Furthermore, contrary to some beliefs, NAFTA was not a cause of the Mexican crisis and is now one of the pillars of that country's economic recovery. Finally, employment losses caused to American workers by NAFTA have been tiny despite the large rise in the US–Mexican wage gap caused by the peso crisis. There is even some evidence that NAFTA has created more jobs than it destroyed.

Still, there remain a number of areas where progress is necessary. The United States and Mexico must contribute to the fulfillment and consolidation of the objectives set out in NAFTA. Several recent incidents underscore the need to deter the influence of powerful lobbies which may conspire against NAFTA's full implementation. An example of the latter in the United States is the decision to unilaterally overrule allowing the passage of Mexican trucks, which in effect constituted a violation of NAFTA. One way to avoid such situations would be to replace national trade remedy laws by an international competition code. This may insulate the trade disputes from political pressures of powerful vested interests. Since the US political climate is not ripe for giving up national trade remedy laws for internationally set codes, the responsibility to make good on NAFTA's commitments rests primarily with the US executive branch.

Additional efforts are necessary to make the institutions contemplated in the labour and environment NAFTA side-agreements more effective. In particular, the US National Administrative Office should be more forceful recommending action on the part of the Mexican government regarding cases where Mexican

workers' freedom of association is violated. In a country where the head of the Mexican equivalent of the AFL-CIO publicly threatens those who will not vote for the official party with retaliation, external pressure can play a significant role in improving the protection of workers' rights guaranteed by Mexican law, but not always in practice. The federal, state and local governments on both sides of the border should also step up their contribution to make more projects eligible for loans from the North American Development Bank. This will require making available non-refundable grants to co-finance projects which have a high social return. Given the proximity, helping Mexican communities to improve their living and environmental conditions can have large pay-offs for the United States.

In December 1994, at the Miami Summit of the Americas, the United States vowed to pursue the economic integration of the hemisphere and form a free trade area by the year 2005. Since then, however, little progress has been made. It is true that the hemispheric working groups created after the Summit are doing the groundwork for that objective to be achieved. But the administration has been slow in requesting fast-track negotiating authority in Congress to begin formal negotiations for Chile's accession to NAFTA. Chile has repeatedly manifested its interest to become a member of NAFTA and has completed free trade agreements with Mexico and Canada. However, its accession to NAFTA has become entangled in US domestic politics.

A laggard United States will not be devastating for economic integration in the hemisphere. However, because of its size, the US market is the biggest prize and, without that prize, the incentives to sustain open economy policies in some of the countries will diminish. Brazil may be a case in point. Brazil is the largest market in Latin America and, therefore, could be a significant lost opportunity for the United States should the process of liberalising trade and non-trade barriers between the two countries not take place. Furthermore, Central America and the Caribbean governments claim that being excluded from NAFTA has had negative effects on their economies already. These are countries whose prosperity and stability are also of vital interest to the United States because they are sources of migratory flows and a conduit for drug trafficking.

Now that the rest of the region is ready to move forward with economic integration, it is rather ironic that the United States after decades of promoting the principle of free trade appears hesitant. This image can only be removed if the Clinton administration moves forward with a request for fast-track negotiating authority and — together with its two partners — negotiates with Chile its accession into NAFTA. Free trade could well be like the proverbial bicycle. Either we continue to move forward or risk falling off.

Finally, the Mexican crisis underscores how macroeconomic events can stand in the way of reaping the benefits of greater economic integration implied by agreements such as NAFTA. The peso crisis points to the need to continue monitoring macroeconomic events in Mexico, and systematically analyse the

impact of US economic trends and policy decisions on the Mexican economy. While seeking full-scale macroeconomic coordination between the two countries would be completely unrealistic at this point, a lot could be accomplished by continuing the close consultations between the authorities of the two countries which developed in the context of the US financial rescue package. While the US has no right to interfere with or dictate Mexican macroeconomic policy (or vice versa), maintaining such consultations could help prevent another crisis or — at the very least — give the US some warning that such a crisis might occur.

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